

Message Text

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C O N F I D E N T I A L SECTION 01 OF 03 OECD PARIS 04836

E FOR COOPER, EUR FOR HARTMAN AND ALBRECHT; EB FOR
KATZ AND BOEKER

PASS TREASURY FOR SOLOMON AND BERGSTEN; CEA FOR SCHULTZE

E.O. 11652: GDS

TAGS: OECD, ECON

SUBJECT: MARCH 1-2 MEETING OF THE ECONOMIC POLICY
COMMITTEE (EPC): THE CENTRAL POLICY ISSUES

REF: A) OECD PARIS 04804; B) CPE(77)1; C) CPE(77)2;
D) CPE(77)3; E) CPE(77)4, F) CPE(77)5

1. SUMMARY AND INTRODUCTION. WITHIN THE INTERRELATED
FRAMEWORK DESCRIBED IN THE MISSION'S OVERVIEW TELEGRAM
(REF A), THE SECRETARIAT, FOR THE FORTHCOMING MARCH 1-2
EPC PLENARY MEETING, SEEKS TO FOCUS DISCUSSION ON
CENTRAL ISSUES OF ECONOMIC POLICY AND BALANCE OF
PAYMENTS ADJUSTMENT OF THE OECD COUNTRIES AT THE PRESENT
JUNCTURE. SECRETARIAT'S DOCUMENTATION SUGGESTS THAT
ECONOMIC POLICY MUST BE FORMULATED IN A CONTEXT WHICH
RECOGNIZES EFFECTS AND FEEDBACKS BETWEEN MACRO ECONOMIC
POLICIES ON THE ONE HAND, AND OTHER ASPECTS OF POLICY,
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PARTICULARLY THOSE AFFECTING THE BALANCE OF PAYMENTS AND
TRADE. IN THE LIGHT OF THESE CONSIDERATIONS, THE ISSUES
POSED FOR THE EPC--IN CONTRAST TO THE PAST--PLACE HEAVY
STRESS ON REACHING A COMMON UNDERSTANDING ON THE
ADJUSTMENT PROCESS AND ON THE ACCEPTABLE DISTRIBUTION OF
THE OECD'S CURRENT ACCOUNT DEFICIT, AS WELL AS ON THE
DIFFERENTIAL POLICIES WHICH STRONG AND WEAK COUNTRIES

SHOULD PURSUE TO ACHIEVE THE DESIRED ADJUSTMENT. (AS REPORTED IN SEPTEL, THE PROPOSED DISCUSSION FOR WP-3 MEETING ON FEBRUARY 28 IS MORE FOCUSED ON MEDIUM TERM BALANCE OF PAYMENTS ADJUSTMENT THAN ON SHORT TERM ISSUES IN THIS AREA.) EPC DISCUSSION ALSO LINKS MACRO AND ADJUSTMENT POLICY TO THE NEED TO REFRAIN FROM RESTRICTIVE TRADE MEASURES. (THIS THEME AS RELATED TO THE TRADE PLEDGE IS BEING PICKED UP IN THE XCSS DOCUMENTATION AS IS BEING REPORTED BY SEPTEL.)

2. SECRETARIAT ALSO FOCUSES EPC'S ATTENTION ON MEDIUM TERM STRATEGY FOR SUSTAINABLE GROWTH ADOPTED BY THE OECD MINISTERS LAST JUNE AND SUGGESTS POLICY IMPLICATIONS OF THE STRATEGY IN PRESENT CIRCUMSTANCES. IT CONCLUDES THAT WHILE U.S. POLICY IS ABOUT ON TRACK, GERMANY AND JAPAN NEED FURTHER STIMULUS, AND U.K., FRANCE AND ITALY MUST SIT TIGHT. SECRETARIAT BELIEVES THAT MEDIUM TERM POLICY STRATEGY SHOULD BE CAUTIOUS BUT ACTIVE; IT IDENTIFIES OBSTACLES TO THE FULFILLMENT OF THE STRATEGY AND DEFINES THE ESSENTIAL PRINCIPLES AND BOUNDARIES WITHIN WHICH POLICIES CONSISTENT WITH THE STRATEGY SHOULD BE SHAPED. IT THUS EXAMINES CONSIDERATIONS RELEVANT TO THE SELECTION OF AN OPTIMAL RECOVERY TRACK AND THE APPROPRIATE ROLE OF POLICIES IN ACHIEVING AND MAINTAINING SUCH A DIRECTION. THE FOLLOWING PARAGRAPHS DESCRIBE THE MAIN LINES OF THE SECRETARIAT'S ANALYSIS AND SUGGESTED POLICY APPROACHES. END SUMMARY

3. MAIN ISSUES FOR DISCUSSION (REF B): AN ANALYSIS
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OF IMMEDIATE NEEDS AND ECONOMIC POLICY REQUIREMENTS, SEEN AGAINST THE MEDIUM-TERM BACKGROUND, BEARS IMPORTANTLY ON THE DISCUSSIONS AT UPCOMING OECD MINISTERIAL. THE OECD'S MEDIUM-TERM STRATEGY AIMS AT GRADUAL, SUSTAINED RECOVERY AND DECLINING INFLATION, BUT THERE ARE SEVERAL OBSTACLES TO ACHIEVEMENT OF THIS GOAL:

(A) CAUTIOUS RECOVERY PATH IMPLIES PERSISTENCE OF HISTORICALLY HIGH UNEMPLOYMENT LEVELS FOR SOME TIME TO COME. THIS COULD LEAD TO PRESSURE FOR "QUICK FIX" REFLATION OR FOR TRADE RESTRICTIONS

(B) TO HELP EASE PROBLEMS OF UNEMPLOYMENT AND INFLATION, SECRETARIAT SUGGESTS GOVERNMENTS PRESS AHEAD ON MANPOWER POLICIES (SEE REF E) AND EXAMINE THE ROLE OF INCOMES POLICIES.

(C) DIFFICULT TO STRIKE BALANCE BETWEEN AVOIDANCE OF

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INFLATION AND WIDENING GAP BETWEEN RECOVERY PATH
TARGETS OF COUNTRIES AND ACTUAL PERFORMANCE. GOVERN-
MENTS SHOULD SET THEIR OBJECTIVES AND THEN MAKE SMALL,
BUT CONTINUOUS, POLICY ADJUSTMENTS IN THE DIRECTION
OF THESE OBJECTIVES (RATHER THAN STOP-GO POLICIES).

(D) DIVERGENCE IN INTRA-OECD ECONOMIC PERFORMANCE.
POLICIES AIMED AT A BETTER DISTRIBUTION OF THE OECD
CURRENT ACCOUNT DEFICIT ARE FUNDAMENTAL:

(I) ABSENCE OF AN UNDERSTANDING ON AN ACCEPTABLE
DISTRIBUTION OF OECD CURRENT ACCOUNT DEFICIT MAY BE
STRATEGIC GAP IN THE SERIES OF INTERCONNECTED UNDER-
STANDINGS AND COMMITMENTS OECD MEMBERS HAVE ENTERED
INTO (I.E., AGREED GROWTH STRATEGY AND TRADE PLEDGE).

(II) DIFFERENTIATED DOMESTIC DEMAND MANAGEMENT POLICIES
AS BETWEEN STRONG AND WEAK COUNTRIES SHOULD PLAY
IMPORTANT PART IN THE ADJUSTMENT PROCESS. POLICIES
IN THIS RESPECT HAVE BEEN LESS THAN PERFECT.

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(III) EXCHANGE RATE MOVEMENTS SHOULD FACILITATE ADJUSTMENT PROCESS. MONETARY AND OTHER POLICIES MUST BE CONSISTENT WITH NEEDS OF ADJUSTMENT PROCESS. WEAK COUNTRIES SHOULD AVOID COMPETITIVE DEPRECIATION; STRONG COUNTRIES SHOULD LET THEIR CURRENCIES APPRECIATE.

(IV) TO REDUCE TOTAL OECD DEFICIT, WE SHOULD REDUCE OIL IMPORTS AND INCREASE DEVELOPMENT ASSISTANCE, AND HENCE OECD EXPORTS TO NON-OIL LDC'S. (THESE POINTS EXAMINED IN MORE DETAIL IN DOCUMENTATION FOR WP-3 (SEPTEL).)

(E) MEASURES TO RESTRICT IMPORTS OR ENCOURAGE EXPORTS (PRESSURES AGAINST TRADE PLEDGE) ARE A POTENTIALLY SERIOUS OBSTACLE TO ACHIEVEMENT OF THE OECD'S ECONOMIC STRATEGY. ON THE OTHER HAND, ACHIEVEMENT OF THE GOALS OF THE STRATEGY WOULD HELP GOVERNMENTS ADHERE TO LIBERAL TRADE POLICIES.

4. ABOVE OBSTACLES ARE HAVING ADVERSE EFFECTS ON OECD ECONOMIC PERFORMANCE. OECD LIKELY TO UNDERSHOOT STRATEGY'S MEDIUM-TERM GROWTH OBJECTIVE (5 - 5.1/2 PERCENT).

5. SECRETARIAT STRESSES STRONG AND WEAK COUNTRY RESPONSIBILITIES UNDER STRATEGY AND IDENTIFIES SLOW PROGRESS IN CURRENT ACCOUNT ADJUSTMENT AS MAIN OBSTACLE TO ACHIEVEMENT OF STRATEGY. SECRETARIAT SUGGESTS EPC FOCUS ON HOW ADJUSTMENT PROCESS COULD BE SPEEDED UP, E.G., APPROPRIATE POLICY ADJUSTMENTS IN AREAS OF DEMAND MANAGEMENT, TRADE, EXCHANGE RATES AND DEVELOPMENT ASSISTANCE AND ENERGY CAN ALL PLAY IMPORTANT ROLE.

6. MEDIUM-TERM STRATEGY IN PRESENT CIRCUMSTANCES (REF C): MAIN CONCLUSIONS ARE:
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(A) INTENT OF THE STRATEGY NOT SLOW GROWTH, BUT TO FIND FASTEST RECOVERY CONSISTENT WITH UNWINDING INFLATION AND INFLATIONARY EXPECTATIONS AND

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HENCE WITH SUSTAINED FULL EMPLOYMENT;

(B) APPROPRIATE RECOVERY PATH DETERMINED IMPORTANTLY
BY "INITIAL CONDITIONS"--E.G., STATE OF INFLATION AND
INFLATIONARY EXPECTATIONS;

(C) RETURN TO SUSTAINED FULL EMPLOYMENT REQUIRES
POLICIES THAT BALANCE TWIN DANGERS OF RESURGENCE OF
INFLATIONARY EXPECTATIONS AND HEIGHTENED PESSIMISM
RE FUTURE OUTPUT AND SALES. STRIKING THIS BALANCE
REQUIRES ACTIVE POLICY STANCE;

(D) TO AVOID INSTABILITY, ACTIVE POLICY NEEDED TO HIT
RECOVERY PATH, BUT MUST BE IMPLEMENTED CAUTIOUSLY AND
MONITORED CLOSELY;

(E) DESIRED RECOVERY TRACK IS A MOVING TARGET. WHEN
A COUNTRY IS OFF THE PATH, NEW PATH CHOSEN MUST
BALANCE RISKS IN (C) ABOVE AND TAKE ACCOUNT OF
CHANGED CIRCUMSTANCES.

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(F) SINCE "INITIAL CONDITIONS" VARY AMONG COUNTRIES,
STRATEGY CALLS FOR DIFFERENTIATED POLICIES.

7. (FYI: ALL EPC DOCUMENTS HAND-CARRIED TO
R. GELBARD, EUR/RPE, BY E. PREEG ON FEB. 16).
KATZ

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